T.C. Memo. 1982-387

Payments received by a partner from a partnership are treated as partnership distributions under Section 731, not sales proceeds under Section 707(a), when the transfer of property to the partnership is deemed a capital contribution, and the payments are contingent and tied to the partnership's operational success.

Summary

Park Realty Co. (petitioner) contributed land to a partnership, White Oaks Mall Co., for development. The partnership agreement stipulated that Park Realty would be reimbursed for pre-development costs upon reaching agreements with anchor stores. The IRS argued this reimbursement was a sale of development costs under Section 707(a), leading to taxable income. The Tax Court held that the transfer was a capital contribution under Section 721, and the payments were partnership distributions under Section 731. The court emphasized that the substance of the transaction, the intent of the partners, and the contingent nature of the payments indicated a contribution, not a sale. Thus, Park Realty did not recognize income from the reimbursement.

Facts

1. Park Realty Co. acquired land for a shopping center development.
2. Park Realty incurred pre-development costs and negotiated with anchor stores (Sears, Ward's, May).
3. Lacking resources, Park Realty formed a partnership, White Oaks Mall Co., with Springfield Simon Co. (Simon).
4. Park Realty contributed the land to the partnership and became the limited partner; Simon was the general partner.
5. The partnership agreement stated Park Realty would be reimbursed $486,619 for pre-development costs upon execution of agreements with anchor stores.
6. The partnership paid Park Realty $486,619 after agreements were secured with anchor stores.
7. Park Realty treated the land transfer as a capital contribution and the payments as partnership distributions, recognizing no gain.
8. The IRS determined the reimbursement was a sale of development costs, resulting in taxable income for Park Realty.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Park Realty's federal income taxes for 1972 and 1975. Park Realty petitioned the Tax Court to contest this determination. The case was submitted fully stipulated to the Tax Court.

Issue(s)

1. Whether payments received by Park Realty from the partnership constitute

proceeds from the sale of property to the partnership taxable under Section 707(a).
2. Or whether these payments are a distribution by the partnership to a partner taxable, if at all, under Section 731.

Holding

1. No, the payments do not constitute proceeds from a sale taxable under Section 707(a) because the substance of the transaction was a capital contribution, not a sale.
2. Yes, the payments are considered partnership distributions under Section 731 because they were contingent reimbursements tied to the contributed property and partnership operations, not payments for a separate sale.

Court’s Reasoning

The Tax Court reasoned that the substance of the transaction, not merely its form, governs whether it is a sale under Section 707(a) or a contribution under Section 721 with distributions under Section 731. The court emphasized:

- **Form vs. Substance:** The transaction was formally structured as a contribution of property to partnership capital, not a sale.
- **Intent of Partners:** The partners intended the land transfer to be a capital contribution.
- **Contingency of Payment:** The reimbursement was contingent on securing anchor store agreements, directly benefiting the partnership’s development. This contingency indicated the payment was tied to the partnership’s success, not a fixed sale price.
- **Integrated Transaction:** The development costs were not separable or valuable apart from the land itself. The reimbursement was for costs related to the contributed land, further supporting the contribution characterization.
- **Distinguishing from Sale:** The court distinguished the situation from a disguised sale, noting that Park Realty transferred its entire interest in the property and was acting as a partner in facilitating the partnership’s goals.
- **Reliance on Otey:** The court referenced *Otey v. Commissioner*, reinforcing the principle that contributions of property followed by distributions can be treated as partnership transactions, not sales, when they are integral to the partnership’s formation and operations.

The court stated, “Petitioner’s conveyance of his entire interest in the land was a contribution of property to a partnership in exchange for an interest in the partnership, sec. 721, and we therefore find the payments by the partnership to petitioner to be distributions within the purview of section 731.”

Practical Implications

Park Realty clarifies the distinction between a sale and a contribution in the context of partnership taxation, particularly concerning reimbursements to partners for pre-formation expenses. Key implications include:

- **Substance over Form:** Courts will look beyond the formal labels to the economic substance of transactions between partners and partnerships. Labeling a payment as a “reimbursement” does not automatically make it a non-taxable distribution if it resembles a disguised sale.
- **Contingency Matters:** Payments contingent on partnership success are more likely to be treated as partnership distributions. Fixed, guaranteed payments are more indicative of a sale.
- **Integration with Partnership Operations:** If the transferred property and related payments are integral to the partnership’s core business and the partner is acting in their capacity as a partner, contribution treatment is favored.
- **Documentation is Key:** Partnership agreements and related documents should clearly articulate the intent of the partners regarding contributions and distributions to support the desired tax treatment.
- **Application in Real Estate Development:** This case is particularly relevant in real estate development partnerships where partners often contribute land or partially developed property and seek reimbursement for pre-development costs. It guides practitioners in structuring these transactions to achieve intended tax outcomes.

Later cases applying *Park Realty* often focus on the degree of risk and contingency associated with the payments and the extent to which the partner is acting as such versus in an independent capacity.

